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Trusts-Banks and Banking-Set-Offs Against Trust Funds

TRUSTS—BANKS AND BANKING—SET-OFFS AGAINST TRUST FUNDS.—Appellee Tractor Company delivered a tractor to an Equipment Company, an independent sales agency, under a conditional sales contract, the Equipment Company executing its note for the wholesale price and assigning the purchase order of its customer and all moneys due thereunder to appellee. The customer, through its treasurer, issued a warrant to the Equipment Company, who indorsed it and deposited it in appellant bank to credit its checking account. The Equipment Company was indebted to the bank on an overdue note, and appellant credited a part of the deposit to its overdue note. Upon suit by appellee for the amount applied to the note, recovery was allowed, and appeal taken. Held, affirmed. The bank, not having changed position in reliance on the buyer's apparent title, nor having given value, could not set off the buyer's pre-existing debt to the bank against a deposit to defeat the conditional seller's claim to the deposit. A bank may not appropriate funds deposited by a trustee in his own name to payment of a personal pre-existing debt of the trustee, even if the bank had no knowledge of the true owner's interest at the time of appropriation of the funds.[1]

There is no doubt that where no other right is involved, money deposited in a bank creates the relation of debtor and creditor between the bank and the depositor, the money becoming the property of the bank, and the bank having the right to apply a sufficient amount of the deposit to the payment of any debt due from the depositor to the bank.[2] At the other extreme, there is no doubt that where the bank knows a third person has an interest in a deposit made in another individual's name, the bank is precluded from applying those funds to the depositor's indebtedness to the bank.[3] However, between these two extremes is an intermediate step in which trust funds are deposited to the trustee's personal account and the bank, not knowing they are trust funds, attempts to apply them to the depositor's indebtedness to the bank.

On this last point, there is a great split of authority, and there has been a further split by distinguishing between cases where the depositor's consent

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[15] Hamilton v. Seamon (1848), 1 Ind. 185; Conklin v. Ogborn (1856), 7 Ind. 553. Also, see Hayden v. Cretcher (1881), 75 Ind. 108.

[1] Peoples State Bank v. Caterpillar Tractor Co. (1938, Ind.), 12 N. E. (2d) 123.

[2] Bedford Bank v. Acoam (1890), 125 Ind. 584, 25 N. E. 713; Lamb, Receiver, v. Morris (1888), 118 Ind. 179, 20 N. E. 746; Second National Bank v. Hill (1881), 76 Ind. 223, 40 A. R. 239; Aurora National Bank v. Dils (1897), 18 Ind. App. 319, 48 N. E. 19.

[3] Shepard v. Meridian National Bank (1897), 149 Ind. 532, 48 N. E. 346; Bundy v. Town of Monticello (1882), 84 Ind. 119; Davis v. Indiana National Bank (1920), 73 Ind. App. 563, 126 N. E. 489; Miami County Bank v. State (1915), 61 Ind. App. 360, 112 N. E. 40; Martin v. First National Bank (1931), 51 F. (2d) 840.

was had to the set-off, where such applications have been allowed,[4] and those where the depositor-trustee has not consented to such application. The weight of authority is against the holding of the principal case,[5] and is, in effect, that the bank where funds are deposited in which a third person has an interest may apply the deposit to the individual debt of the depositor, so long as it has no notice nor knowledge sufficient to put it on guard as to the character of the deposit.[6] This line of authority would seem to follow the federal cases, although there seems to be some confusion as to what the federal rule actually is.[7] The policy of this line of cases, refusing recovery of trust funds applied to the depositor's personal debt, is that if recovery were permitted and a duty of inquiry as to the source from which the debtor acquired the money thus imposed on the bank, the effect would be to disorganize business operations and entail a great amount of uncertainty and risk on business.[8]

As contrasted to this rule, there is the so-called "equitable rule," which states that a bank though having no knowledge, either express or implied,

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[4] McEwen v. Davis (1872), 39 Ind. 109 (Partner deposited partnership funds to his own credit, the bank had no knowledge of the character of the funds, and the bank was allowed, with consent of the depositor, to apply the fund to satisfaction of the depositor's note); Metz v. First National Bank (1928), 45 Ida. 472, 262 P. 1051; Shuman v. Citizen's State Bank (1914), 27 N. D. 599, 147 N. W. 388; Tough v. Citizen's State Bank (1913), 89 Kan. 583, 132 P. 174; First State Bank v. Hill (1911, Tex. Civ. App.), 141 S. W. 300; Kimmell v. Bean (1904), 68 Kan. 598, 75 P. 1118; Smith v. Des Moines National Bank (1899), 107 Iowa 620, 78 N. W. 238.

[5] Supra, note 1.

[6] Kemfner v. Auburn Park Trust & Savings Bank (1931), 344 Ill. 200, 176 N. E. 363; Clay County Bank v. First National Bank (1929), 12 S. W. (2d) 595, 178 Ark. 989; Metz v. First National Bank (1928), 45 Ida. 472, 262 P. 1051; First National Bank v. Duncan (1927), 127 Okl. 226, 260 P. 491; Cable v. Iowa State Savings Bank (1923), 197 Iowa 393, 194 N. W. 957; Arnold v. San Ramon Valley Bank (1921), 184 Cal. 632, 194 P. 1912; Steere v. Stock Yards National Bank (1921, Tex. Civ. App.), 266 S. W. 531; McStay Supply Co. v. Stoddard (1912), 35 Nev. 284, 132 P. 545; First National Bank v. Kenney (1911), 116 Md. 24, 81 A. 227; Shuman v. Citizen's State Bank (1914), 27 N. D. 599, 147 N. W. 388; Kimmell v. Bean (1904), 68 Kan. 598, 75 P. 1118; Hatch v. Fourth National Bank (1895), 147 N. Y. 184, 41 N. E. 403; Wilson v. Farmer's First National Bank (1914), 176 Mo. App. 73, 162 S. W. 1047; Garrison v. Union Trust Co. (1905), 139 Mich. 392, 102 N. W. 978; Titcomb v. Richter (1915), 89 Conn. 226, 93 A. 526; Burnham v. Holt (1843), 14 N. H. 367. This view is expressed also in Pomeroy Eq. Jur., Sec. 1048, and by the American Law Institute's Restatment of Law of Trusts, Sec. 324 (h), which reads, "If a bank in which trust funds have been deposited accepts in payment of a personal indebtedness of the trustee to the bank a check payable out of the trust fund, the bank is liable for participation in the breach of trust if, but only if, it had notice that trust funds were being so used."

[7] Central National Bank v. Conn. Mutual Life Ins. Co. (1881), 104 U. S. 54, 26 L. Ed. 409; Union Stock Yards Bank v. Gillespie (1889), 137 U. S. 411, 11 S. Ct. 118; In Re Greater Pythian Temple Ass'n of New York (1937), 19 F. Supp. 762; Commercial National Bank v. Stockyards Loan Co. (1926), 16 F. (2d) 911. But see Citizens & Southern Bank v. Fayram (1927), 21 F. (2d) 998, which holds that there must be a change of position, which would make the Indiana cases come under the rule as set out in this case.

[8] Hatch v. Fourth National Bank (1895), 147 N. Y. 184, 41 N. E. 403.

that a third person has an interest in the funds deposited, cannot apply those funds to the indebtedness of the individual depositor, unless the bank has changed its position, given value, or unless superior equities have been raised in its favor.[9] In these cases, there is no distinction, and apparently no cause for distinction between an express trustee and an agent, bailee, collector of rents, or anyone else in a fiduciary capacity.[10] Indiana follows this equitable rule and there seems to be no doubt that it will continue to do so. The principles which the Indiana courts follow are so well settled and deeply rooted in the history of the cases that there is no question which rule precedent points out. The reasoning of the Indiana Courts is that if the fund in question is a trust fund, its character is not changed by a deposit to the individual account of the trustee, and unless it has passed into the hands of parties for value without notice, the court will separate the trust funds from other funds, if there has been a co-mingling, and restore them to the beneficiary.[11] The point stressed in this line of authority is not lack of knowledge or notice, but that the fund must have passed into the hands of a party for value, a bona fide purchaser. It is to be noticed that the cases which permit the set-off and refuse recovery do not take into consideration this factor that value is given and that the holder is a bona fide purchaser. Better reasoning would seem to favor the line of authority followed in Indiana, as there is no reason for treating trust funds differently from other trust property; and it should be possible for a beneficiary to follow the fund until it does come into the hands of a bona fide purchaser for value, at which time a superior equity would arise in favor of that purchaser. Where the bank has not changed its position or lost anything by the deposit which it has attempted to apply to the trustee's indebtedness, there is no reason for allowing the set-off, thus fostering a conversion of trust funds. And where such set-off is attempted, it is such a conversion of trust funds as to bring the case within the language of the Indiana rule, that the bank is liable "if it participates in the profits or fruits of the fraud."[12] R. K. R.

SECURITY—DISTRIBUTION OF PROCEEDS.—In return for a sum then borrowed a certain trust company took two notes that were secured by a single mortgage. The notes were for $500 and $3,500 respectively and matured at the same

[9] Brown v. Maquires Real Estate Agency (1937, Mo.), 101 S. W. (2d) 41; Allen Dudley & Co. v. First National Bank (1932), 122 Neb. 443, 240 N. W. 525; Agard v. Peoples National Bank (1927), 116 Minn. 438, 211 N. W. 825; Gibbs v. Commercial & Savings Bank (1926), 50 S. D. 134, 208 N. W. 779; Shotwell v. Sioux Falls Savings Bank (1914), 34 S. D. 109, 147 N. W. 288; Cady v. South Omaha National Bank (1896), 46 Neb. 756, 65 N. W. 906; Burtnett v. First National Bank (1878), 38 Mich. 630.

[10] Central National Bank v. Conn. Mutual Life Ins. Co. (1881), 104 U. S. 54, 26 L. Ed. 409.

[11] Porter v. Roseman (1905), 165 Ind. 255, 74 N. E. 1105; Pierce v. Dill (1897), 149 Ind. 136, 48 N. E. 788; Citizen's Bank v. Harrison (1891), 127 Ind. 128, 26 N. E. 683; Bundy, Receiver, v. Town of Monticello (1882), 84 Ind. 119; Rottger, Receiver, v. First Merchants' National Bank (1933), 98 Ind. App. 139, 184 N. E. 267; Terra Haute Trust Co. v. Scott (1932), 94 Ind. App. 461, 181 N. E. 369; Continental National Bank v. McClure (1916), 60 Ind. App. 553, 111 N. E. 191; Shoppert v. Indiana National Bank (1907), 41 Ind. App. 474, 83 N. E. 515.

[12] Miami County Bank v. State (1915), 61 Ind. App. 360, 112 N. E. 40.